# Normalizing Income Statements

# Course Instructor – Jeff

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## About Jeff…

Prior to joining CFI, for over a decade Jeff taught financial modeling and valuation to thousands of students all over the world. Before his career in financial education, Jeff covered approximately 50 companies with a combined market cap of $500 billion during his career in equity research. He also worked in corporate development leading M&A modeling and due diligence, and FP&A, as well as working in investment banking and restructuring. Jeff has a B.S. from Texas A&M University and obtained his MBA from the University of Houston. He is a CFA charterholder.

# Course Introduction

During any given accounting period, there will usually be **non-recurring or unusual gains or losses that impact a company's financial statements.**

- Identifying non-recurring items or unusual gains or losses is a crucial skill for financial analysts.
- Removing them from the income statement results in a normalized income statement.
- The aim is to determine the company's ongoing profitability, excluding these one-off items.

# Learning Objectives

Identify the most common non-recurring items on an income statement.

Adjust the income statement for non-recurring items and other factors impacting comparability.

Analyze adjusted income statements to better understand a company's true operating performance.

# Finding Adjustable Items

Finding non-recurring or unusual items requires a solid understanding of accounting and an ability to read financial reports.

It is a time-consuming process, but companies are willing to highlight what they think requires adjusting.

Nearly every company in the S&P 500 index reports adjusting items (called non-GAAP adjustments or non-IFRS adjustments).

Adjustments almost always make the results better, but most analysts will try to match the company-reported adjustments.

# Common Non-Recurring Items

Some of the most common non-recurring adjustments include:

01. Restructuring Costs
02. Acquisition/Merger-Integration Costs
03. Litigation or Regulatory Gain/Loss
04. Gain/Loss on Sale of Assets
05. Impairments
06. Impairment Reversal (IFRS only)
07. Gain/Loss on Early Extinguishment of Debt
08. Discontinued Operations

# Restructuring Costs

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## 01. Restructuring Costs

Companies periodically restructure their operations:

Restructuring Costs or Initiatives

# Acquisition/Merger-Integration Costs

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## 02. Acquisition/Merger-Integration Costs

These are costs that relate to one-time expenses incurred after a company acquires another company.

# Litigation or Regulatory Gain/Loss

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### 03. Litigation or Regulatory Gain/Loss

- Lawsuits
- Regulations

These can result in one-time gains or losses.

# Gain/Loss on Sale of Assets

Some of the most common non-recurring adjustments include:

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### 04. Gain/Loss on Sale of Assets

Occasionally, companies sell assets that are not ordinarily in their course of business.

- Gains occur when a company sells for **more than book value.**
- Losses occur when a company sells for **less than book value.**

# Impairments

Some of the most common non-recurring adjustments include:

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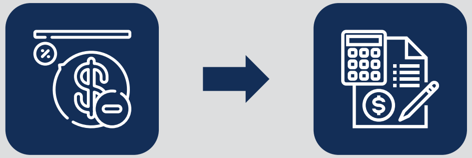
## 05. Impairments

Companies are required to write down assets if the fair value of those assets falls below the book value.



# Reversal of Impairments (IFRS only)

Some of the most common non-recurring adjustments include:

01. Restructuring Costs
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06. **Impairment Reversal (IFRS only)**
07. Gain/Loss on Early Extinguishment of Debt
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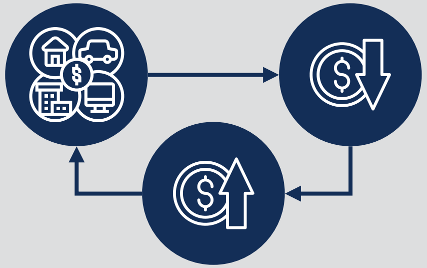
## 06. Impairment Reversal (IFRS only)

If the company reports under IFRS and the asset has since recovered value, then the company is allowed to reverse a previously taken impairment.



# Gain/Loss on Early Extinguishment of Debt

Some of the most common non-recurring adjustments include:

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## 07. Gain/Loss on Early Extinguishment of Debt

Companies may decide to retire some debt early (i.e., when interest rates fall).

Companies will issue new debt at lower interest rates and use the cash received to repay the higher interest rate debt.

# Discontinued Operations

Some of the most common non-recurring adjustments include:

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02. Acquisition/Merger-Integration Costs

03. Litigation or Regulatory Gain/Loss

04. Gain/Loss on Sale of Assets

05. Impairments

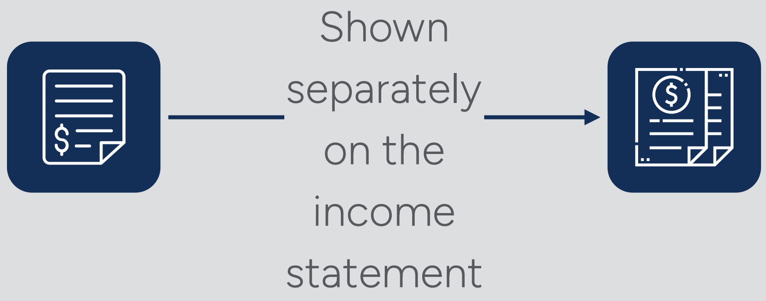
06. Impairment Reversal (IFRS only)

07. Gain/Loss on Early Extinguishment of Debt

**08. Discontinued Operations**

## 08. Discontinued Operations

Occurs when companies decide to dispose of a business unit but haven't as of the reporting date.



# Adjustments for Companies & Analysts

There are other common adjustments that both companies and analysts perform when normalizing results.

- Amortization of Intangible Assets
- Amortization of Debt Discount/Deferred Financing Costs
- Stock-Based, or Equity-Based, Compensation
- LIFO Reserve (US GAAP only)

# Amortization of Intangible Assets

There are other common adjustments that both companies and analysts perform when normalizing results.

In order to be recognized on a balance sheet, most intangible assets must be **acquired from a different company.**

Many intangible assets have a specific, useful life and are, therefore, **amortized over this useful life.**

When intangible assets are invested in through R&D and marketing, the **costs are expensed as incurred.**

To ensure comparability, **companies adjust for amortization expenses** from acquired intangible assets.

- **Amortization of Intangible Assets**
- Amortization of Debt Discount/Deferred Financing Costs
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# Amortization of Debt Discount/Deferred Financing Costs

There are other common adjustments that both companies and analysts perform when normalizing results.

These are non-cash expenses that are **typically included in interest expense.**

Companies sometimes suggest these costs be adjusted to better see the **actual cash interest expense.**

| | |
|---|---|
| Amortization of Intangible Assets | **Amortization of Debt Discount/Deferred Financing Costs** |
| Stock-Based, or Equity-Based, Compensation | LIFO Reserve (US GAAP only) |

# Stock-Based, or Equity-Based, Compensation

There are other common adjustments that both companies and analysts perform when normalizing results.

This is a non-cash expense relating to **employee stock options and restricted stock.**

Companies will suggest adjusting it since **it's not an actual cash expense** like salaries and bonuses.

- Amortization of Intangible Assets
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- **Stock-Based, or Equity-Based, Compensation**
- LIFO Reserve (US GAAP only)

# LIFO Reserve (US GAAP only)

There are other common adjustments that both companies and analysts perform when normalizing results.

Companies can choose **different inventory valuation methods which distorts comparability.**

**FIFO** assumes the first items in inventory are sold first and **LIFO** assumes the last items are sold first.

LIFO-using companies **must provide extra disclosures** so they can be compared to FIFO-using ones.

In order to enhance comparability, companies and analysts will **adjust for LIFO as appropriate.**

Amortization of Intangible Assets

Amortization of Debt Discount/Deferred Financing Costs

Stock-Based, or Equity-Based, Compensation

LIFO Reserve (US GAAP only)

# Tax Implications

Since most adjustments reduce expenses, income taxes will increase compared to the reported results.

This is due to the **tax deductibility** of these expenses.